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Intelligence

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Ref - 1-2-84

Saudi Arabian Oil Policy: Motivations and Objectives

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Interagency Intelligence Memorandum

~~Secret~~

NI IIM 87-10012
August 1987

Copy 335

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SAUDI ARABIAN OIL POLICY: MOTIVATIONS AND OBJECTIVES

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Information available as of 30 July 1987 was used in the preparation of this Memorandum, approved for publication on 7 August 1987 by the Chairman of the National Intelligence Council.

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SCOPE NOTE

This Memorandum examines how domestic, regional, and international variables shape Saudi Arabia's oil policy, how it might react to various market scenarios, and how its decisions affect US and Western interests. The paper, prepared under the auspices of the National Intelligence Officer for Economics, focuses on the most likely course of events over the next two to three years. 25X1

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KEY JUDGMENTS

Saudi Arabia's oil policy aims at attaining sufficient oil revenues to meet domestic economic needs while maintaining market stability and oil prices near current levels—levels Saudi Arabia believes will assure a long-term market for its oil. With about 170 billion barrels of proved reserves, Saudi Arabia could produce at current rates for a century. The specific elements of King Fahd's strategy in the short term are:

— To earn oil revenues of about $20 billion a year over each of the next two years in order to maintain government spending and minimize further reductions in foreign reserves.

— To maintain oil prices of at least $18 per barrel, perhaps with moderate increases over the next two years. The Saudis fear that large increases in prices would undermine the long-term market for their oil.

— To assert Saudi predominance in order to force OPEC member cooperation on price and production.

This approach is intended to meet the Saudis' long-term objectives by discouraging development of new oil supplies, constraining the growth of petroleum substitutes, and encouraging increased consumption. Riyadh believes this strategy will allow Saudi Arabia to muddle through until the early 1990s, when the Saudis expect the demand for their oil to rise and prices to increase. The linchpin of the strategy is a gradual rise in the demand for OPEC oil that will allow for an increase in quotas and growing revenues at near current prices over the next two years.

Financial considerations increasingly constrain Saudi policy. Oil revenues have dropped from nearly $100 billion in 1981 to about $20 billion currently. The decline led to budget and current account deficits of nearly $15 billion in 1986. Liquid reserves have fallen by more than 50 percent since 1982 to about $50 billion, and some of these reserves already are dedicated to important social programs such as government pensions. [redacted] 25X1
[redacted] Saudi Arabia has been reluctant to resort to overseas borrowing, but this option remains. 25X1

The King's power is not absolute. In making decisions to cut government spending further, Fahd must minimize the impact on several important constituencies, including the royal family (with more than 4,000 princes), the military and security services, and the business community.

We expect the King's political authority to remain unchallenged as long as his policies succeed. Fahd's now-public responsibility for oil policy, however, has increased the potential cost to him of a perceived failure. Further serious declines in oil revenues could lead senior princes to question his policy and to demand a greater voice in decisionmaking. Fahd's flexibility on the budget and hence that on his oil policymaking also are limited by foreign aid obligations that remain a key foreign policy and security tool. Saudi Arabia's foreign aid expenditures totaled about $4.8 billion last year, and Riyadh is likely to maintain significant aid levels to key recipients—Iraq, Syria, Jordan, and the PLO.

We believe chances are about even that the Saudis can make it through the next two to three years without having to initiate another price war to attempt to teach other oil producers another lesson. It is likely to be a trying period, however. The Saudis will have to make further budget reductions, may agree to a small increase in oil prices to bolster domestic revenues, and might even borrow abroad to help mitigate the rate of reserve drawdown. In addition, they probably will have to allow other Persian Gulf countries to produce over quota while moderating their own output to keep prices from falling.

Should market conditions worsen and the level of overproduction by other OPEC members continue or increase, Saudi Arabia initially would make major, high-level efforts to reach accommodation with other OPEC members. If these failed, it would be likely to increase production drastically, initiating another price war. Saudi Arabia probably would not benefit financially from such a move in the short term, but would feel the tactic necessary to assert its dominance within OPEC and to ensure the political gains it made both internally and externally from initiating its "Saudi-first" policy.

On balance, we believe Saudi oil policy is favorable to US interests. The current price of oil is closer to the market price than those that prevailed before the 1986 collapse, and Saudi Arabia's interest in maintaining its long-term market is likely to keep prices lower than at least several other OPEC members might want. Even if the Saudis are forced to increase production significantly, the United States would tend to benefit. In this case, the much lower prices that would result are likely to be only temporary, as in 1986. In addition, those harmed by lower oil prices include countries such as the USSR, Iran, Libya, and Syria, although obviously some oil producers friendly to the United States would also be hurt. A policy of increased production, however, would

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heighten the chance of confrontation between the moderate Gulf states and Iran.

Saudi oil strategy in the 1980s has been dominated largely by revenue considerations. Over the longer term, however, oil market conditions are likely to change, leaving the West more dependent on Persian Gulf oil supplies and easing Saudi Arabia's economic problems.

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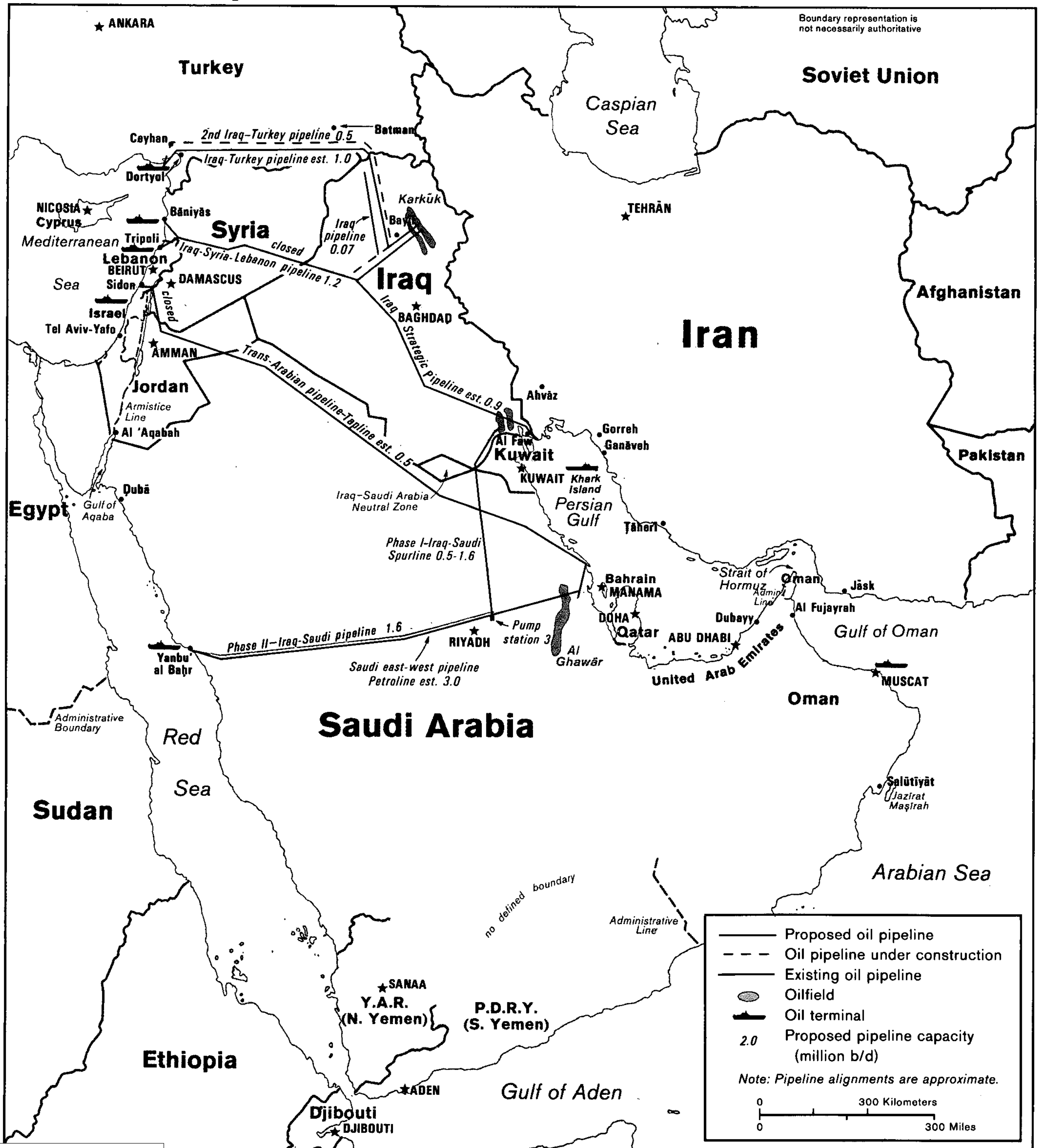
Figure 1
Selected Middle East Pipelines



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DISCUSSION

1. The dramatic fall in oil revenues after the early 1980s forced Saudi Arabia to redefine its oil strategy and has focused attention on the costs of failure of its current strategy of maintaining price and production levels. King Fahd has placed his credibility on the line by assuming personal responsibility for these policies. We believe the key elements of the King's oil strategy are:

— To earn oil revenues of about $20 billion a year over each of the next two years in order to maintain government spending and to minimize further reductions in foreign reserves.

— To maintain oil prices of at least $18 per barrel, perhaps with moderate increases over the next two years. The Saudis fear that large increases in prices would undermine the long-term market for their oil. They want oil prices at levels sufficiently low to discourage development of non-OPEC supplies and of oil substitutes and to encourage increased consumption in the industrial countries.

— To assert Saudi predominance to force OPEC member cooperation on price and production. [redacted]

2. Riyadh has reasserted its control in OPEC but, as part of its short-term strategy, is willing to play a limited and temporary role as swing producer to support prices. Riyadh expects small price increases combined with slowly rising demand for OPEC oil to reinforce producer discipline and eliminate the need for the Saudis to produce below their OPEC quota. In addition, the Saudis hope to obtain the support of non-OPEC producers for their efforts to maintain market stability. Fahd believes this oil strategy and prices near current levels through the end of the decade will provide Riyadh with the resources to achieve its modest economic goals. [redacted]

The December 1986 Accord

The central role played by Saudi Arabia in engineering the December 1986 OPEC accord reflects its intention to assert its dominance within the cartel, and Riyadh's actions since then demonstrate a strong desire to guarantee the success of the agreement. The Saudis have lobbied members to keep within the OPEC-mandated quotas and have promoted Gulf Cooperation Council solidarity on oil matters to gain additional leverage within OPEC. When forced to choose last March whether to allow the agreement to unravel or to become the de facto swing producer, Riyadh chose the latter. Saudi production in March fell to 3 million barrels per day—nearly 30 percent below quota—while most other members produced at or above their quotas. [redacted] 25X1

The Saudis apparently believed that temporarily reducing their production was preferable to renewed price volatility, which would complicate their attempt to redress pressing economic and political problems. Still, stepping back into the role of swing producer and forfeiting revenue, regardless of the reason, risked upsetting the new aggressive image Riyadh sought to project. Although Saudi Arabia still could use the threat of another drastic price slide to try to keep producers in line, OPEC members recognize Riyadh's reluctance to instigate a price slide and its readiness within limits to bear the brunt of upholding yet another agreement. Even Kuwait, one of Saudi Arabia's closest allies in OPEC in terms of long-term goals, has grossly exceeded its OPEC production limit, thrusting more of the burden on Saudi Arabia. Nevertheless, Riyadh's commitment to maintain at least the $18 price was reaffirmed in the decision at the June 1987 meeting to forgo a fourth-quarter increase in OPEC quotas. [redacted] 25X1

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Narrowing Economic Choices

3. The driving force behind short-term Saudi strategy is the regime's need for revenue. Over the past few years, the Saudis have been working primarily to mitigate the negative impact of the oil-induced recession by developing stopgap solutions. We expect Riyadh's oil policy over the next two years to continue to reflect this preoccupation. [redacted] 25X1

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4. Riyadh's options for dealing with the lingering recession brought on by declining oil prices and export volumes have narrowed over the past few years. Oil revenues have dropped from nearly $100 billion in 1981 to about $20 billion currently. This decline led to budget and current account deficits of nearly $15 billion in 1986. Although the Saudis have managed the decline relatively well, the huge drop in income has

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Figure 2
Saudi Arabia: Economic Indicators

Note scale change

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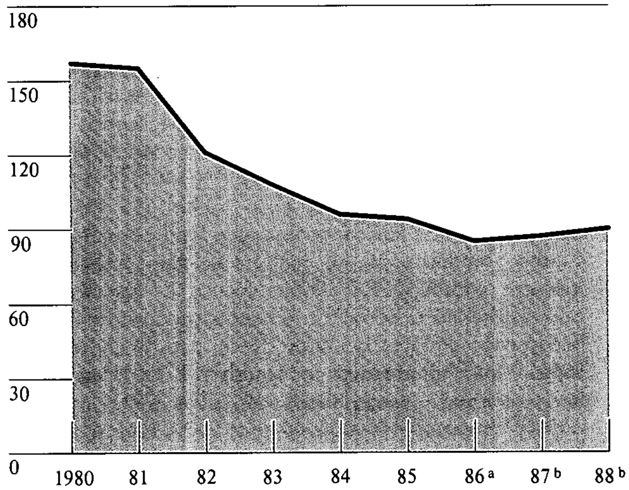
Real GDP, 1980-88

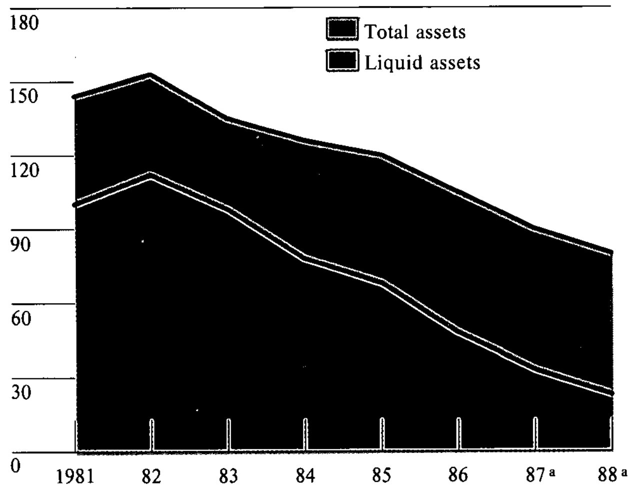
Billion $ US



[a] Estimated.
[b] Projected.

Official Foreign Assets, Yearend 1981-88

Billion $ US



[a] Projected.

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Saudi Arabia: Current Account, 1982-88 [a]

Billion US$

	1982	1983	1984	1985	1986 [b]	1987 [c]	1988 [d]
Exports (f.o.b.)	74	46	37	28	24	25	29
Oil	74	45	36	26	22	23	29
Nonoil	0	1	1	2	2	2	2
Imports (f.o.b.)	34	33	29	20	18	19	21
Net services	32	29	28	20	20	25	27
Balance	0	−16	−19	−12	−15	−19	−19

[a] Because of rounding, columns may not add to totals shown.
[b] Estimated.
[c] Projected. Assumes crude oil production of 4.3 million b/d and oil price of $18 per barrel.
[d] Projected. Assumes crude oil production of 4.3 million b/d and oil price of $20 per barrel.

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left the government facing serious economic problems. Riyadh has cut domestic spending and attempted to increase revenues while shielding key interest groups. It also has reduced imports and foreign aid. These measures have been insufficient to offset oil revenue declines, however, and to cover shortfalls the government has resorted to drawdowns of its international financial assets. Since 1982 liquid reserves have fallen by more than 50 percent to about $50 billion, and some of these reserves already are dedicated to important social programs such as government pensions. In addition, the Saudis have incurred arrearages of as much as $15 billion, mainly in the form of delayed payments to contractors.

5. The government plans to continue to trim its budget, but finding new areas to cut without negatively affecting key interest groups has become increasingly difficult.

6. The key premise of King Fahd's strategy is a gradual recovery in the demand for OPEC oil—on which current Saudi budget projections are based. If Saudi oil revenues fall over the next two years as a result of lower-than-anticipated oil demand or even greater "cheating" by other OPEC members, Riyadh would be forced to undertake further large reductions in government expenditures to avoid drawing down reserves by more than $15 billion a year—a rate at which liquid reserves would be depleted in about three years. The government would trim even politically sensitive programs—defense, subsidies, and foreign aid—which account for roughly 50 percent of this year's planned spending and which have been spared the brunt of past reductions. We believe these and other austerity measures, such as tax increases, could generate at least $5 billion over each of the next two years to offset oil revenue declines. Saudi Arabia might also undertake discreet overseas borrowing. 25X1

7. Belt tightening efforts would increase public dissatisfaction with the government and especially with the royal family. A prolonged and severe economic downturn would present a growing political problem for Fahd, as significant segments of Saudi society—including prominent royal family members—began to feel more intensely the impact of the King's cost cutting measures. 25X1 25X1

Domestic Political Constraints 25X1 25X1

8. ***The Saudi Royal Family.*** As head of the Al Saud, Fahd is responsible for promoting the interests of individual family members as well as the family as a whole. 25X1 25X1

9. ***The Military and Security Services.*** The government has largely insulated military and security

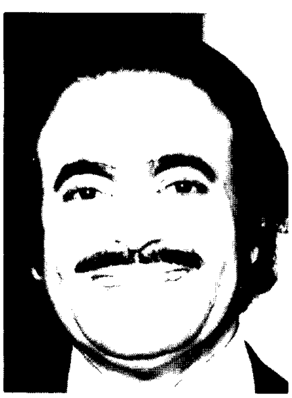
Figure 3
Key Saudi Personalities

King Fahd

Age 66 . . . accession to throne in 1982 coincided with fall in world oil prices and sharp drop in Saudi revenues . . . King under growing domestic pressure to reinvigorate slumping economy . . . desires to control all aspects of oil policy . . . has autocratic ruling style . . . is proponent of raising oil prices gradually in order to maintain market stability . . . force behind December OPEC agreement on prices and production. [redacted] 25X1

Defense Minister Sultan

Age 62 . . . Defense Minister for nearly 25 years . . . aggressive, ambitious, and hard-working full brother of King Fahd . . . shares Fahd's general policy outlook . . . has assumed prominent role as his key adviser and confidant on oil matters . . . demonstrated willingness to use oil barter agreements to finance major military arms purchases. [redacted] 25X1



Oil Minister Nazir

Age 54 . . . replaced Oil Minister Yamani in October 1986 . . . served as deputy oil minister 1962-68 . . . architect of Saudi economic and development plans . . . trying to streamline Saudi petroleum operations and marketing . . . implementer of policy rather than creator of Kingdom's oil strategy . . . defers to Fahd on policy questions but has proved to be effective spokesman. [redacted] 25X1

personnel from budget reductions in order to ensure a strong and loyal military. Since the decline in oil revenues in 1982, government spending on defense has declined but has remained a relatively constant proportion of the budget—about 30 percent—and Riyadh has focused on maintaining salary and benefit levels for military personnel. With the apparent approval of King Fahd, Defense Minister Sultan has made greater use of ad hoc financing arrangements, especially oil barter deals, for the procurement of multibillion-dollar weapon systems. [redacted] 25X1

10. ***The Business Community.*** Many in the business community believe they have been forced to assume an unfair share of the burden of the economic downturn [redacted] 25X1 25X1 Government agencies have delayed payments, renegotiated or canceled contracts,

[redacted] 25X1

and drastically reduced capital outlays for development projects. The regime is sensitive to grumbling by businessmen and bankers. Since last fall, the Saudi Arabian Monetary Agency has released several billion dollars for the settlement of overdue government debts to private contractors. Such payments probably are intended to help stimulate the private sector and to help restore the business community's confidence in the regime. [redacted]

11. ***Religious Leaders.*** Support of the ulama—religious leaders—is indispensable to the royal family. As a constituency, however, they are the least interested in maintaining high oil revenues. They are not against high oil revenues per se, but fear the corrosive influence of excessive wealth on conservative Saudi society. [redacted]

Fahd's Insular Style

12. Although Saudi monarchs have always had the primary responsibility for developing and implementing the Kingdom's oil strategy, King Fahd has assumed a more public and active role than previous monarchs. This reflects Fahd's traditional autocratic decision-making style, which leads him to rely on a small circle of loyal advisers for guidance. [redacted]

[redacted] 25X1

13. Fahd was the driving force behind Saudi Arabia's initiative to raise oil prices to $18 per barrel, and it was the King's impatience with what he perceived as lukewarm support for his plan that contributed to the downfall of Yamani and Tahir. With Yamani's departure, however, [redacted] 25X1 25X1 25X1 25X1

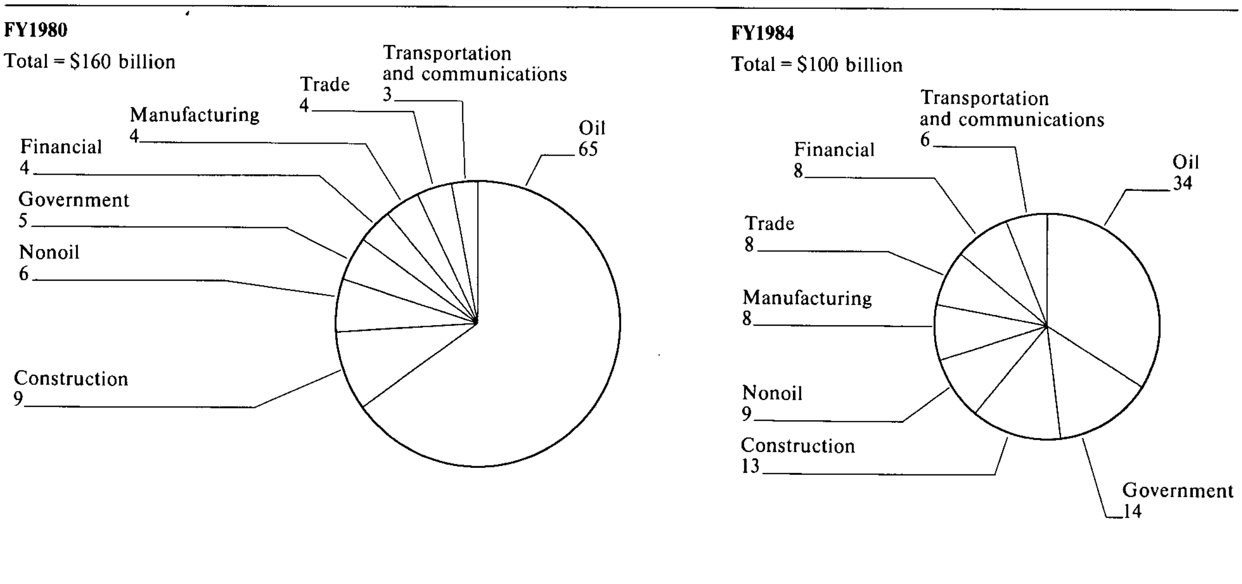
External Factors Shaping Oil Policy [1]

14. ***Iran and Iraq.*** The nearly seven-year-old Persian Gulf war and its impact on regional stability continue to dominate Riyadh's foreign policy agenda. 25X1 25X1

[1] Figure 5 shows recent benchmarks in Saudi oil policy. [redacted] 25X1

Figure 4
Composition of Saudi GDP, FY1980 and FY1984

Percent



[redacted]

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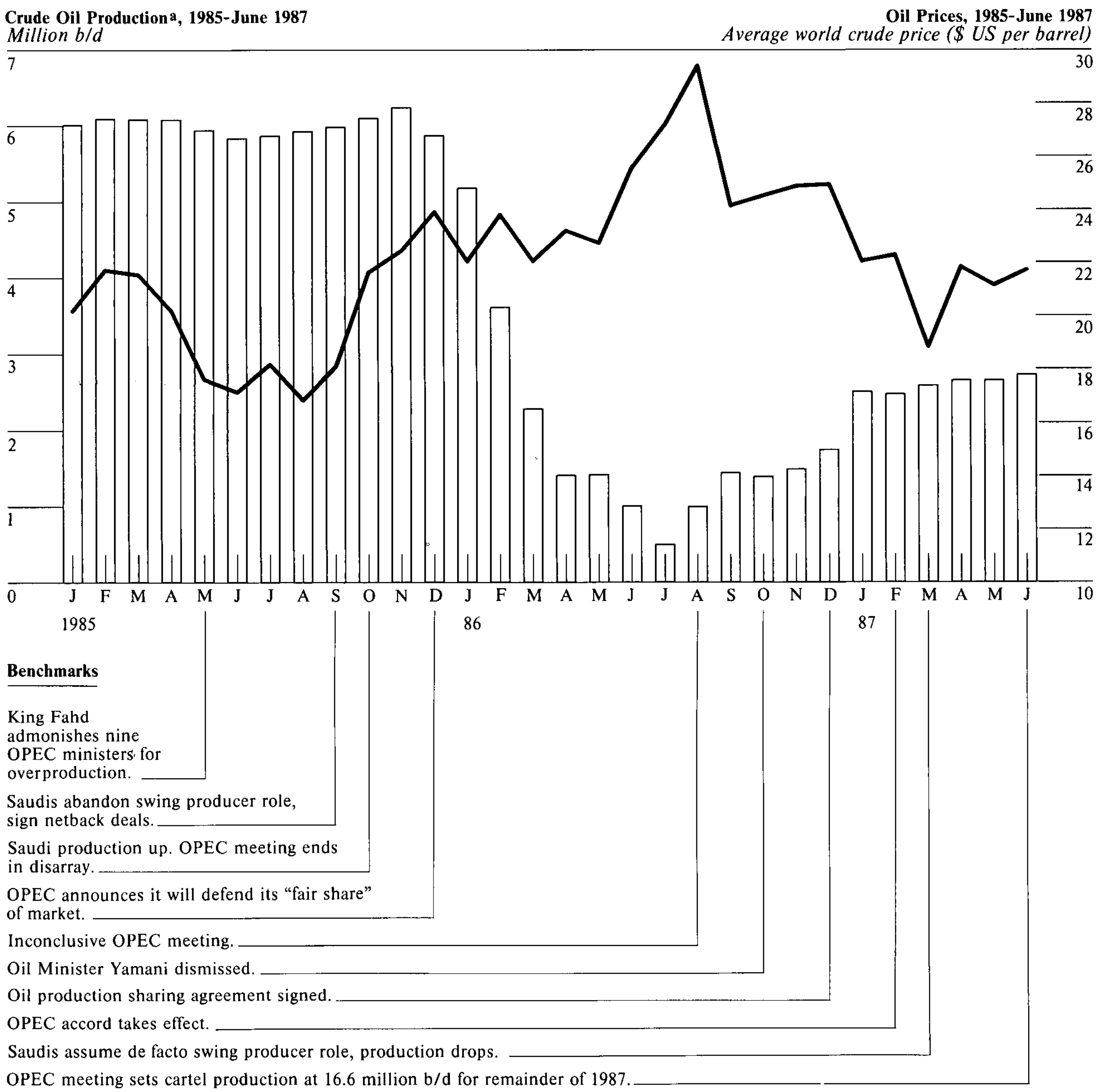
Figure 5
Trends in Saudi Oil Policy

Note scale change



[a] Includes Saudi share of Neutral Zone production.

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[redacted] 25X1

The Saudis fear the fighting could escalate and spread down the Gulf. Saudi support for the Iraqi war effort—including about $1.7 billion in financial assistance in 1986—has not waned. [redacted] 25X1 25X1 The Saudis, however—well aware that Iran will remain a major Gulf power regardless of the war's outcome—also have maintained a political dialogue with Tehran, and assumed a nonconfrontational stance within OPEC. On occasion, Riyadh has made marginal concessions to Iran. Riyadh apparently believes contacts with Iran will have a moderating influence on the Iranian regime and lessen the chance that the war will spread. [redacted] 25X1

15. We expect the Saudis to find it very difficult over the two- to three-year period covered by this Memorandum to balance their divergent, and often competing, foreign and oil policy objectives without assuming a more confrontational stance toward either Iran or Iraq. Iran is pressing the Saudis to force Baghdad to limit production. Iraq has refused to accept any OPEC quota not at least equal to that of Iran. Iraqi production—currently about 2 million b/d and expected to rise to as much as 2.5 million b/d this fall—is well in excess of its implied OPEC quota of 1.5 million b/d and is an increasing irritant. Iraq is likely to export as much oil as it can, including the full 500,000 b/d of additional capacity through Turkey, despite protests from Riyadh. Although the Saudis sympathize with Iraq's need to generate additional revenue to fight the war, overproduction could become significant enough to undermine Riyadh's efforts to stabilize the market. If oil market conditions weaken, and the slump is due in any degree to Iraq's increasing output, the Saudis are likely to reduce the flow of Iraqi oil through the Saudi Petroline, or reduce Neutral Zone oil sales on Iraq's behalf. [redacted] 25X1

16. ***Checkbook Diplomacy.*** Foreign aid also is an important foreign policy and security tool for Saudi Arabia even though financial constraints have diminished the size of its program—Saudi bilateral aid totaled about $4.8 billion last year, down from its peak of $8.7 billion in 1981. Riyadh uses foreign aid to foster regional consensus, support the Arabs against Israel, promote its influence over moderate and radical regimes, strengthen allied regimes, and secure protection. In addition, it lends assistance to non-Arab recipients for which it expects support for Arab positions in international forums and reductions in ties to Israel. [redacted]

[redacted] 25X1

17. Riyadh is likely to maintain relatively high levels of aid to several key recipients and will seek to maintain income sufficient to do so. Nonetheless, the government will try to allocate assistance more strictly according to a recipient's needs and immediate concern to Saudi Arabia. Allocations to such recipients as Syria, Jordan, and the PLO probably will continue, but even aid to these entities may be trimmed next year. Riyadh will maintain support for Iraq, but, barring an increase in hostilities with Iran, is likely to cut its aid somewhat as Baghdad's oil production increases. In addition, Riyadh probably will boost aid to Egypt to further its security and foreign policy objectives. [redacted] 25X1

18. ***The West.*** Saudi decisions on oil policy will remain heavily influenced by Riyadh's desire for a stable oil market and a sound world economy in order to:

— Retain fundamental US security guarantees to forestall potential aggressors.

— Guarantee a long-term market for its oil. 25X1

[redacted] 25X1

— Preserve the value of its financial assets.

— Increase West European and Japanese economic ties to Saudi Arabia.

While Riyadh will maintain ties to the United States it also is seeking to diversify its bases of international support. This trend will lead Riyadh to pursue closer ties to West European states. [redacted]

The Challenge of the Market

19. Future non-Communist demand for oil is a key variable in the ability of Saudi Arabia to attain its goals. OPEC's December 1986 agreement to raise and stabilize oil prices at $18 per barrel in 1987 so far has been largely successful. With non-Communist consumption increasing about 1 percent in 1987—assuming an average oil price of $18 per barrel and OECD economic growth of about 2.5 percent—and a small decline in non-OPEC oil production, demand for OPEC crude is expected to average about 17.5 million b/d this year. Indeed, it could be significantly higher if companies build inventories in response to tensions in the Persian Gulf. [redacted]

20. Even at the expected level of demand for OPEC oil, however, no OPEC member can produce all it wishes and maintain the current price level. At the same time, increasing Iraqi production will force other members to limit production increases to prevent a weakening in prices. Most members are financially pressed, however, and will be reluctant to cede any market share to Iraq. All members have a strong interest in protecting their respective market shares within OPEC, particularly since production restraint to support prices will continue to be required over the balance of the 1980s. [redacted]

21. If OECD economic growth falters by even 1 percent from current forecasts, we estimate that oil demand would decline by as much as 500,000 b/d. As the world's residual supplier, OPEC—and particularly Saudi Arabia—would bear the brunt of this decline. Lower output of this magnitude would cost the cartel some $3 billion in oil revenues annually. [redacted]

22. Even if the market cooperates, the Saudis will come under increasing pressure from other OPEC members, especially Iran, to increase prices more quickly. Tehran has long advocated a return to the former benchmark price of $28 per barrel. To lessen its own short-term financial pressures and to avoid excessive discord with Iran, Riyadh may be somewhat flexible in negotiating price increases. Saudi Arabia, however, has so far remained steadfast in protecting its long-term interests, and we believe it will work hard to temper price increases. [redacted] 25X1

23. Saudi Arabia's determination to maintain market stability, willingness to play a temporary and limited role of swing producer to accomplish this end, and market conditions give Saudi Arabia about an even chance to achieve its goals over the next two years. Riyadh would consider maintenance of the OPEC agreement a success and an affirmation of Saudi Arabia's power. Nonetheless, we believe the government would react cautiously to its victory and try to avoid raising the expectations of Saudi citizens more rapidly than it could meet them. We expect substantial internal debate over Fahd's handling of oil policy and the budget, even under the most optimistic set of assumptions. [redacted] 25X1

24. Saudi oil production must average 4.3 million b/d this year and prices average $18 per barrel, if Saudi oil revenues are to reach Riyadh's goal of at least $20 billion this year. While this increase would constitute a one-third improvement over last year's oil earnings, the additional revenue probably would have only a marginal effect on overall economic growth. Planners in both the public and private sectors would be reluctant to initiate new projects in the uncertain economic climate likely to prevail for at least the next year. [redacted] 25X1

25. Despite lingering uncertainty about the oil market, the positive psychological impact of the increase in oil revenues probably would serve both the Saudi economy and regime stability. The government would be able to forestall further large spending cuts and more easily fund programs of importance to key interest groups. But its efforts to streamline government bureaucracy, privatize public-sector industries, and take other austerity measures would continue. Riyadh also would proceed with its reassessment of its foreign aid program, reducing assistance as planned regardless of improvements in its economic fortunes. [redacted] 25X1

26. In the event the market does not accommodate increasing OPEC production, pressure will increase rapidly on Fahd to abandon the OPEC strategy. Saudi Arabia initially would try to avoid this step by making major, high-level efforts to reach an accommodation with other OPEC members. If this failed, we believe Saudi Arabia would increase output dramatically, and let prices slide. The specific point at which Fahd would initiate this aggressive production policy is not clear. A significant acceleration in the current rate of reserve drawdown or a fall in liquid reserves to an

[redacted] 25X1

unacceptably low level—particularly if either is a result of cheating by other OPEC members—could trigger this action. The Saudis probably would not benefit financially in the short term from another price war, but Riyadh would feel the tactic necessary to assert its dominance in OPEC and to ensure the political gains it made both internally and externally from initiating its "Saudi-first" policy. [redacted]

27. A significant decline in oil revenues would strain the Saudi economy, but the degree of lasting damage would depend on the size and duration of the decline. The Saudi economy has proved more resilient than most analysts predicted in the early years of the recession. Since then its economic choices have narrowed, but we believe Riyadh can continue to muddle through its problems much as it has over the past few years for the next two years even if revenues fall to 1986 levels. In this case, however, US interests in a stable internal situation in Saudi Arabia could be challenged. We would expect substantial internal debate and grumbling over Fahd's handling of oil policy and the budget. [redacted]

28. On balance, we believe Saudi oil policy is favorable to US interests. The current price of oil is closer to the market price than the prices that prevailed before the 1986 collapse, and Saudi Arabia's interest in maintaining its long-term market is likely to keep prices lower than at least several other OPEC members might want. Even if the Saudis are forced to increase production significantly, the United States would benefit to some extent. In this case, the much lower prices that would result are likely to be only temporary, as in 1986. In addition, those harmed by lower oil prices include countries such as the USSR, Iran, Libya and Syria, although obviously some oil producers friendly to the United States would be hurt. A policy of increased production, however, would heighten the chance of confrontation between the moderate Gulf states and Iran. [redacted] 25X1

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Longer Term Factors

29. Saudi oil strategy in the 1980s has been dominated largely by revenue considerations. By the 1990s, however, oil market conditions are likely to change, leaving the West more dependent on Persian Gulf oil supplies and easing Saudi Arabia's economic problems. [redacted] 25X1

30. Saudi Arabia's cautious oil policy could be altered by events beyond Saudi control that push political considerations to a dominant position. Such events, although unlikely, include:

— A clear Iranian victory in the Iran-Iraq war that left Iran in a position to exercise great coercion on all of the Gulf states. This could cause the Saudis to accept a higher price and lower market share than they otherwise would desire. 25X1

— A renewed Arab-Israeli war. This could cause the Saudis to feel compelled to go along with some form of oil embargo as in 1973 even if they knew it would hurt their economic interests.

[redacted] 25X1

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